Visa Business and Economic Insights

U.S. Economic Outlook

Keeping calm and carrying on?

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These days, it seems that the weeks are filled with contradictory economic data. Case in point, in the last few weeks we learned that consumer spending (adjusted for inflation) held up better than expected, maintaining a 3.1 percent annualized pace for the month relative to the robust 3.8 percent rate in the first quarter. In fact, spending was so robust to start Q2 that inflation pressures resumed for the month. Job gains continued to hold up in May and a proxy for income growth based on the employment report pointed towards another solid increase in wage income for the month. Even the housing market appears to be bouncing off its lows from earlier this year.

But these positive trends stand at odds with ongoing softness in manufacturing data and rising layoff announcements. At the core of this dichotomy lies an important concept that is key to understanding the future direction of economic growth: the difference between economic data that help us understand current activity (coincident indicators) and those that help provide clues to the future direction of economic growth (leading indicators). The Conference Board provides two such indicators that aggregate a number of these coincident and leading indicators. The growth gap between these two measures is historically wide (Figure 2), but the findings suggest that while measures of current economic activity are holding their own, the leading indicators foretell a rocky road ahead for gross domestic product (GDP) growth.

We maintain that GDP growth is set to contract beginning in the third quarter of this year and likely again in Q4 but hesitate to call such a short, shallow downturn a recession. Today's ongoing tight labor market suggests that such a slowdown in growth would likely be minimally disruptive to the consumer side of the economy. Even with a slowdown in growth this year, we expect GDP growth to rise 1.1 percent this year and another 1.5 percent in 2024.

Key Points:

- Leading indicators continue to soften
- GDP growth expected to contract in Q3-2023
- One more rate hike now likely

Fig. 1: Real gross domestic product (GDP)
(SA, CAGR and YoY* percent change)

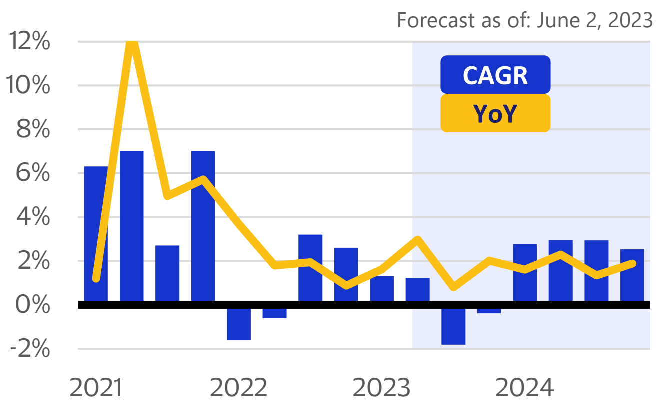
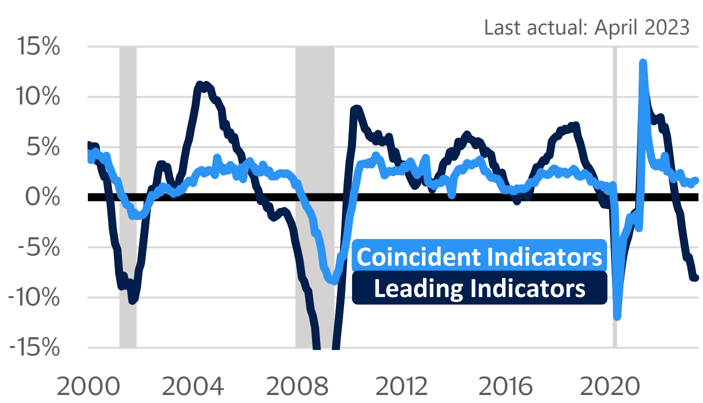


Fig. 2: Leading Index vs. Coincident Index
(YoY* percent change)



*Seasonally adjusted (SA), compound annualized growth rate (CAGR), year-over-year (YoY).
Sources: Visa Business and Economic Insights, U.S. Department of Commerce, and the Conference Board.

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Consumer spending to carry the water

April's consumer spending data showed Q2 was off to a robust start and if the May employment report is any indication, spending likely held up in May as well. But signs of underlying softness in the leading indicators can be seen on the consumer side of the economy as well. For starters, consumer confidence fell for the second month in a row as consumers viewed the labor market as somewhat softer than it was just before the pandemic. While headline job growth remained strong in May, average weekly hours worked were trimmed relative to the same time last year. Employers in a tight labor market like today's tend to cut hours worked before they resort to laying off workers, which gives such a measure its leading indicator properties. These leading indicators point towards a softening, but not an outright contraction, in consumer spending in the months ahead. Even with the contraction in GDP growth we are forecasting in H2 of this year, we see nominal consumer spending rising 3.4 percent YoY in Q4 and, after adjusting for inflation, real consumption growth rising 0.9 percent for the quarter.

Among the key factors likely to keep the contraction in GDP growth short and shallow is the ongoing tight labor market. Job openings data along with continued robust hiring trends suggest that at least some workers who lost their jobs were able to find another position relatively quickly. The tight labor market is also helping to keep many consumers above water in light of persistent inflation pressures. Wage gains remain robust, while inflation has moderated relative to this time last year. This dynamic led inflation-adjusted income growth to swing from deeply negative at the end of last year to rising 3.4 percent YoY as of April. In the absence of large-scale layoffs, it is hard to see a prolonged contraction in consumer spending, which accounted for a little more than 68 percent of GDP in the first quarter of this year.

Business investment likely to take it on the chin

While we expect consumption growth to steady the economy, business investment will likely be the key factor that drags down GDP growth. The downfall of a handful of financial institutions has led to less liquidity in the banking system. This combined with the rapid pace of interest rate hikes from the Federal Reserve will likely keep business investment plans on hold. Larger firms can benefit short-term by stocking away excess cash in Treasuries earning a better yield while smaller businesses are likely struggling to get credit.

We expect business investment to contract by 5.3 percent (annualized) in Q3 and a further 2.3 percent in Q4 of this year. With such an uncertain economic environment, firms will likely remain reluctant to rebuild inventories which is expected to weigh on both the manufacturing sector and by extension overall GDP growth. Early signs that such a trend is occurring can already be seen in a key leading indicator for the sector, the ISM Manufacturing Index, which showed that new orders pulled back sharply in May to the second weakest reading in three years.[1]

Risks to the outlook

Following our refreshed forecast this month, we see the risks to the outlook as roughly balanced. The largest near-term downside risk, the debt ceiling, is now off the table. However, concerns over persistent inflation and a tight labor market may force the Fed to hike rates even higher than we have built into the outlook, further weighing on the business sector. On the upside, strength in hiring activity and wage growth could easily help lift real incomes higher, thus avoiding much of a downshift in consumer spending. While we added an additional rate hike to this month's outlook, fewer hikes or talk of lower rates could prove a catalyst for business to ramp up investment.

	Actual					Forecast			Actual		Forecast	
	2022				2023				2021	2022	2023	2024
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
Gross Domestic Product (CAGR)	-1.6	-0.6	3.2	2.6	1.3	1.2	-1.8	-0.4	5.9	2.1	1.1	1.5
Personal Consumption	1.3	2.0	2.3	1.0	3.8	1.2	-1.1	-0.3	8.3	2.7	1.6	1.2
Business Fixed Investment	7.9	0.1	6.2	4.0	1.4	2.1	-5.3	-2.3	6.4	3.9	1.4	0.5
Equipment	11.4	-2.0	10.6	-3.5	-7.0	-0.3	-11.2	-5.7	10.3	4.3	-3.2	-1.1
Intellectual Property Products	10.8	8.9	6.8	6.2	5.2	1.6	-1.9	-0.2	9.7	8.8	3.9	1.8
Structures	-4.3	-12.7	-3.6	15.8	11.0	9.9	1.4	0.9	-6.4	-6.6	6.2	0.9
Residential Construction	-3.1	-17.8	-27.1	-25.1	-5.4	-6.3	-9.9	-0.5	10.7	-10.6	-13.8	-1.0
Government Purchases	-2.3	-1.6	3.7	3.8	5.2	2.3	3.3	2.0	0.6	-0.6	3.3	2.1
Net Exports Contribution to Growth (%)	-3.1	1.2	2.9	0.4	0.0	-1.4	0.7	0.1	-1.3	-0.4	0.4	0.0
Inventory Change Contribution to Growth (%)	0.2	-1.9	-1.2	1.5	-2.1	0.5	-1.2	-0.3	0.2	0.7	-0.7	0.1
Nominal Personal Consumption (YoY % Chg.)	11.5	9.2	8.6	7.5	7.3	6.0	4.2	3.4	12.7	9.1	5.2	3.1
Real Personal Consumption (YoY % Chg.)	4.8	2.4	2.2	1.7	2.3	2.1	1.2	0.9	8.3	2.7	1.6	1.2
Nominal Personal Income	-3.5	3.2	4.6	5.1	5.5	5.3	3.6	1.2	7.4	2.3	3.9	2.8
Retail Sales Ex-Autos	14.0	12.3	11.3	8.1	5.9	1.6	1.1	0.5	17.2	11.3	2.2	1.8
Consumer Price Index	8.0	8.6	8.3	7.1	5.8	3.9	2.8	3.1	4.7	8.0	3.9	2.2
Federal Funds Rate (Upper Bound)	0.50	1.75	3.25	4.50	5.00	5.25	5.50	5.50	0.25	2.50	5.31	3.25
Prime Rate	3.50	4.75	6.25	7.50	8.00	8.25	8.50	8.50	3.25	4.86	8.31	6.25
10-Year Treasury Yield	2.32	2.98	3.83	3.88	3.48	3.56	3.38	3.19	1.45	2.95	3.40	3.08

Forecast as of: June 2, 2023

Interest rates presented are end of quarter rates

Note: Annual numbers represent year-over-year percent changes and annual averages

Sources: Visa Business and Economic Insights, U.S. Department of Commerce, U.S. Department of Labor and Federal Reserve Board.

[1] Institute for Supply Management, "May 2023 Manufacturing ISM Report On Business," June 1, 2023

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